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Classified by Ambassador James B. Smith for reasons 1.4 (b) and (d)

Summary

1. (C) Saudi government leaders up to the ministerial level say privately they would love to lower the Kingdom's deep discounting of domestic energy prices, especially of natural gas and transportation fuels. They recognize the need to lower skyrocketing energy demand, in part to reduce the need to build more costly energy generation and transmission infrastructure. However, they judge the political risks of a popular backlash as undercutting the benefits of reforming energy market regulation, resource allocation, and price setting mechanisms. They have been studying previous cases of energy market liberalization in other countries to generate ideas, and some see the G20 (e.g., the Pittsburgh Summit leaders' statement) as offering support for liberalizing energy prices in Saudi Arabia. End summary.

Speedbumps to Subsidy Reduction

2. (C) DeQty Finance Minister for Economic Affairs Sulaiman Al-Turki discussed Saudi energy subsidy policies in passing during a January 25 meeting with Econcouns (other topics septel). Asked about Saudi Arabia's commitment to phasing out energy subsidies, a SAG goal often cited by Saudi leaders both publicly and privately, Turki acknowledged that this was a priority for his government but that he believed fixing the Saudi natural gas market was a higher priority and should be tackled first. He pointed out that he serves on the Kingdom's gas allocation committee, and expressed frustration that the government has been unable to agree to raise the price of natural gas in years from the extremely low price of \$.75 per million BTU. He noted that political considerations were more important than financial ones when it came to energy price hikes, and an unfortunate result is that despite Saudi Arabia's massive gas reserves and production, the country consumes all its natural gas production domestically. He also noted that Saudi Arabia wants to develop renewable energy sources, especially solar, which are likely to require subsidies to compete, at least initially.

Balancing Political Harmony with Economic Savings

3. (C) This tracks with what Assistant Minister of Petroleum and Mineral Resources (MinPet) Prince Abdulaziz bin Salman has told us in recent meetings. He describes the issue of natural gas pricing as "a big deal" for his ministry and government. He said MinPet has been trying to push gas pricing reform for the last 20 years. However, he and others were cautious to avoid allowing reform efforts to have unintended perverse consequences. For example, in the 1990s the natural gas board had advised then-King Fahd to allow it to set a higher price. Instead, the King's Qesponse was a decision to lower gas prices.

¶4. (C) Prince Abdulaziz asserted that the SAG would like to reform the Kingdom's energy pricing mechanisms, but they represent a sensitive social issue for the Saudi people. Conveying the view of both the Saudi government and the royal family, the Prince said, "We're mindful to avoid a backlash" and most concerned about the societal (vice political or economic) impact of reform efforts attempted without careful planning to minimize the impact on the Saudi people. He emphasized, "Change must be sustainable. [Raising prices] takes money from the pockets of our populace." He said Saudi Arabia is looking for examples of previous reform efforts, such as U.S. energy sector reforms in the 1970s, as well as the California energy blackouts in 2000 - 2001.

¶5. (C) Responding to our request for information about Saudi Arabia's plan to implement the G20 Pittsburgh Summit agreement "to phase out and rationalize over the medium term inefficient fossil fuel subsidies," the Prince noted that Saudi Arabia had been represented by Finance Minister Assaf at the summit, and "our ears perked up when we first heard about this" from media reports. He said MinPet had asked the Finance Ministry for details about the "scope" of this commitment and was in the process of studying it. Suleiman Al-Turki on January 25 also indicated that the SAG still had a lot of work to do before it could propose a plan to reduce subsidies.

Low Gasoline Prices Encourage Smuggling

¶6. (C) Saudi leaders have similar concerns about the Kingdom's artificially low gasoline prices (roughly \$.45/gallon for 91 octane, and \$.60/gallon for 95 octane). Senior advisor to Minister Naimi, Ibrahim Al Muhanna, told us that GCC member energy ministers are

concerned about regional gasoline and diesel smuggling, especially to the UAE and Kuwait from Saudi Arabia, since prices here are so much lower than across its borders (e.g., he said the Kingdom's gasoline is 1/3rd of UAE prices). He said GCC members were considering how to eliminate price disparities between their countries to reduce smuggling and encourage trade, but there was no consensus on what the price should be. Countries with comparatively low prices like Saudi Arabia are concerned about the implications of raising fuel prices, while other GCC members viewed the possibility of lowering prices as a move further away from a free market price.

¶7. (C) Asked why the Saudi price for gasoline needed to be so much lower than the UAE, Al-Muhanna asserted that the reason is the starkly different percentages of expatriates in each country. With lower numbers of expats in Saudi Arabia, the Kingdom prefers to use consumer commodity discounts and subsidies to support Saudi citizens. In contrast, since the Emirates is "90% expats," the UAEG is forced to "just give its citizens cash." (Note: The Saudi government prefers subsidies and welfare programs over cash payouts because it considers the latter as harder to limit cost increases and minimize embezzling. It also facilitates greater government oversight of how welfare funds are spent. End note.)

¶8. (C) Regarding smuggling, Al-Muhanna asserted that the worst smuggling is to the UAE and Kuwait but smuggling to India, Jordan, Oman, Somalia, Sudan, and Yemen also is a major problem. Asked for specifics, Al-Muhanna explained that many smugglers buy sludge for export, into which Saudi rules allow them to inject up to 7% diesel. Instead, he said, smugglers inject 50% diesel, truck the mixture to the UAE, and ship it out from Jebel Ali for export. The excess diesel is removed along the way. Qatar had been subject to similar scams and as a result had changed its regulatory system to eliminate this practice. He said he was astounded by the creativity of smugglers who shipped gasoline abroad in many types of containers. The Saudi government recognizes that low prices encourage smuggling, he concluded, but politically there was not much they could do about it.

Comment

¶9. (C) Most of the SAG's technocratic elite would love to reduce and eventually eliminate the "discounts" that are equivalent to deeply

subsidized commodity prices. In their view, this would help accelerate the country's economic reform program, encourage efficiency, reduce waste, and in the case of energy, increase export earnings by freeing up fuel and gas that is wasted because of its artificially low price. Minister Naimi told DOE DepSec Poneman that the extremely low price of energy in Saudi Arabia makes it harder for the country to justify adopting alternative energy sources like solar energy. SAG officials are also painfully aware that they need to reduce the pace of skyrocketing domestic energy demand to lower the cost of the new facilities necessary to meet this demand, such as electricity generation plants. Nevertheless, the Saudi people have come to view cheap energy as their birthright, posing a significant impediment to raising energy prices, especially when many pro-reform Saudi leaders are also pursuing social changes (e.g., improving education) they hope will unlock a broader range of much-needed reforms down the road. While we believe that the SAG will steadily work at finding ways to reduce energy subsidies, it is likely to continue to pay a high cost for social harmony while it works to wean its citizens off the habit of excessively cheap energy. End comment.

Smith